



OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

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November 24, 2010

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended September 30, 2010. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees and employees who elect to participate in the Guaranteed Retirement Income Plan. There were approximately 5,800 active members and 5,600 retirees participating in the ERS as of September 30, 2010.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 8.72%, 31 basis points behind the 9.03% gain recorded by the policy benchmark. For the one year period ending September 30, 2010 the ERS' gross return (before fees) was a gain of 12.40%, 61 basis points ahead of the 11.79% gain recorded by the policy benchmark. The one-year return, after fees, places the ERS' performance in the top 17% of a universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was a loss of 0.35%, after fees, ranking in the top 25% of the universe. The asset allocation at September 30, 2010 was: Domestic Equities 25.9%, International Equities 18.9%, Fixed Income 26.1%, Inflation Linked Bonds 10.2%, Commodities 5.0%, Private Equity 6.5%, Private Real Assets 3.2%, Opportunistic 2.9%, and Cash 1.3%. We estimate that the funded status of the ERS was 77.4% as of September 30, 2010, a slight increase from the June 30, 2010 level. The actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

Major Initiatives

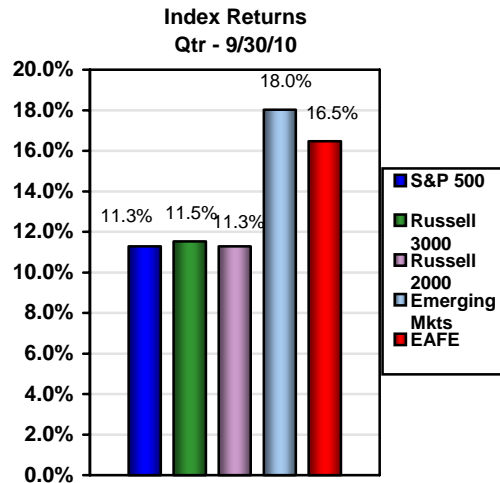
During the quarter, the Board approved restructuring the Large Cap US Equity allocation. Within the Private Real Assets sector, the Board approved an investment of \$20,000,000 in EnerVest Energy Institutional Fund XII. In addition, Staff conducted meetings with several investment managers, including a minority owned emerging manager fund-of funds, to discuss their market outlook, investment process and various strategies.

Capital Markets and Economic Conditions

Real GDP rose 2.0% during the third quarter on an annualized basis compared with a revised 1.7% for the second quarter. Positive contributions came from private inventory investment, exports, personal consumption expenditures, and non-residential fixed investment. Offsetting these contributions were reductions in residential fixed investment and an increase in imports. The U.S. manufacturing sector, as measured by the Institute of Supply Management's (ISM) Composite, expanded for the fourteenth consecutive month in September. These statistics are indicative of economic growth and the potential for

business expansion and higher employment in the future. Employment conditions have yet to materially improve during the recent period of recovery and the unemployment rate remains near 10%. There has been some improvement in the labor market, with the average duration of unemployment shortening.

Public Equity Markets: The U.S. equity markets ended the third quarter with strong gains due to an improved economic outlook, the Federal Reserve's reassurances that it would take actions to support growth, and earnings momentum. Earlier in the quarter, the markets were led by defensive stocks with

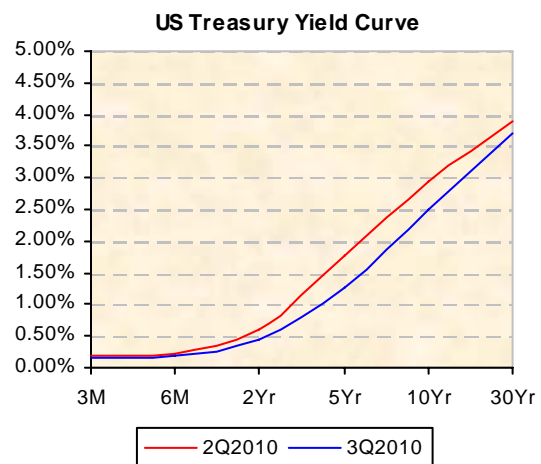


predictable patterns of sales and earnings growth. In contrast, the late quarter rally was led by cyclical sectors as positive economic data eased investors' concerns about a double-dip recession. All major domestic indexes participated in the rally as shown in the chart to the left, with the S&P 500 having its best September performance since 1939. All sectors of the S&P 500 posted positive returns during the quarter with Telecom, Materials, and Consumer Discretionary sectors advancing the most. Our combined domestic equity performance was a gain of 10.63%, underperforming the 11.53% gain recorded by the Russell 3000 benchmark.

Within the international equity sector, developed markets, as measured by the MSCI EAFE Index, were up 16.48%. European equities rallied on positive results of the stress tests for the region's major banks, the easing of concerns over government finances, and better sentiment amid economic reports. Emerging markets advanced 18.03%,

continuing the strong performance from prior quarters. Cyclical sectors, such as materials, industrials and consumer discretionary outperformed on continued global demand and improved economic outlook. Our combined international equity performance was a gain of 15.70% for the quarter, underperforming the 16.58% gain recorded by the MSCI ACWI ex-US Index.

Fixed Income: Treasury yields fell again during the third quarter. Since April 2010, yields have fallen about 115bps to levels at or below 2008 credit crisis lows. The yield on the 10-year Treasury dropped below 2.50%, the lowest level since 1954. The Federal Reserve maintained its target rate at a 0% - .25% range while reiterating its view that current economic conditions warrant exceptionally low levels for an extended period and announced it is prepared to implement additional quantitative easing measures. The yield curve (shown in the chart to the right) flattened as the 2 year Treasury bond fell 18 bps to 0.43% while the 10 year Treasury bond fell 43 bps to 2.51%. Credit spreads tightened over the quarter, especially in the high yield sector and long-term bonds outperformed shorter maturities as investors searched for yield. For the quarter, the Merrill Lynch High Yield Master II Index rose 6.62%, the Barclays Aggregate Bond Index gained 2.48% and the Barclays Long Govt/Credit Index returned 5.85%. Our combined fixed income performance for the quarter was a gain of 6.24%, outperforming the 5.48% gain recorded by the benchmark index. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 7.36% for the quarter, compared to the 3.55% return of the benchmark.



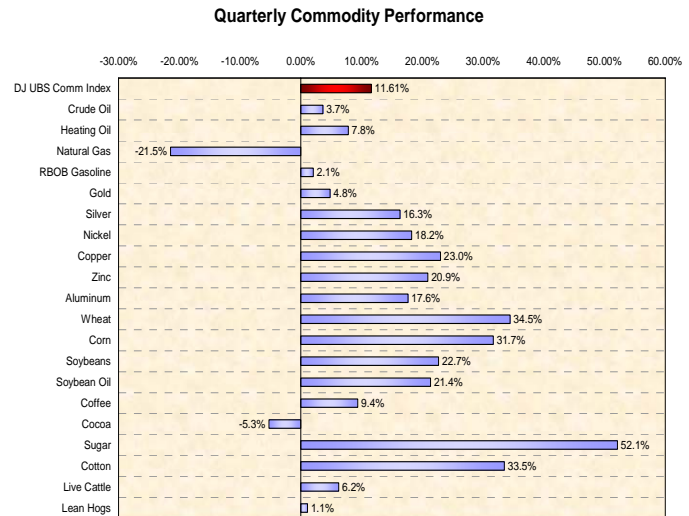
Private Equity: Competition for private equity deals remains high, as private equity firms still have significant uninvested capital, or "overhang", at their disposal. However, overhang estimates are beginning to show a downward trend for the first time in years, indicating that competition may ease. A slowdown in manager fundraising and recent increased investment activity are cited as reasons for the decrease in overhang. During the quarter, our private equity managers called a combined \$3.5 million

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and paid distributions of \$2.9 million. Our current allocation to private equity is 6.5%, with a market value of \$169.5 million.

Private Real Assets: After showing a modest price recovery during the first half of 2010, the Moody's/REAL U.S. Commercial Property Price Index fell during the third quarter and is at its lowest level since June 2002. Since its peak in October 2007, the index has fallen 45%. The data underlying the index reveal that the highest quality properties in major cities, including New York, Washington, DC, and San Francisco, recovered sharply from their 2009 lows, while distressed assets continued to fall in value. Since commercial real estate fundamentals lag the economy and continue to weaken, the number of assets considered distressed are rising. While negative for properties acquired in the 2005-2007 time frame, this is affording investors today the opportunity to purchase properties at relatively attractive prices. During the quarter, our managers called a total of \$5.9 million and paid distributions of \$0.3 million. Our current allocation to private real assets is 3.1%, with a market value of \$81.8 million.

Commodities: The DJ UBS Commodity Index advanced 11.61% for the quarter. All major sectors were up except the energy sector which was impacted by the 21.5% decline of the natural gas sub-sector. A declining dollar and the improving outlook for the global economy increased the demand for raw materials during the quarter. Agricultural (+28.6%), Softs (+27.3%), and Industrial Metals (+20.3) sectors were the best performing sectors. On an individual commodity level, sugar rallied 52.1% on bad weather news in China and Russia along with a dramatic fall-off in Brazil's production. Wheat advanced 34.5% on declining global production and increased U.S. demand. Corn was up 33.5% on news that global demand will outstrip supplies. All industrial metals, led by copper, benefited from the ongoing global demand. During the quarter, our commodities portfolio advanced 11.07%, slightly behind the 11.61% gain recorded by the DJ UBS Commodities Index.



Additions

The primary sources of additions for the ERS include contributions from members and employers and investment income. The following table displays the source and amount of additions for the quarter ending September 30, 2010 and fiscal year-to-date.

Employees' Retirement System

Contributions and Investment Income (millions)

	Qtr 9/30/2010	Fiscal YTD
Employer Contributions	\$ 30.2	\$ 30.2
Member Contributions	4.6	4.6
Net Investment Income	203.4	203.4
	<u>\$ 238.2</u>	<u>\$ 238.2</u>

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

**Employees' Retirement System
Deductions by Type (millions)**

	Qtr 9/30/2010	Fiscal YTD
Benefits	\$ 44.2	\$ 44.2
Refunds	0.5	0.5
Administrative Expenses	0.6	0.6
	<u>\$ 45.3</u>	<u>\$ 45.3</u>

Outlook

Reversing much of the second quarter's losses, capital markets were strong in the third quarter, particularly the month of September. During the quarter, the Federal Reserve began hinting that it would act to counter slowing growth through a second round of quantitative easing ("QE-II"), involving the purchase of U.S. Treasury debt to keep interest rates low. In early November, the Fed announced that it would purchase \$600 billion of U.S. Treasuries through June 30, 2011. This met market expectations but resulted in criticism from Chinese and German officials as they viewed the move as exacerbating global currency imbalances. Equity and credit markets continued their strength into October, and the VIX index (a gauge of the market's expectation for future volatility) continued to decline from its recent highs in May 2010.

Internationally, European exports benefited from the Euro currency's sharp decline during the first half of the year. The Euro rallied throughout the third quarter, which should reduce the relative attractiveness of European goods relative to goods produced in the United States. In the emerging markets, Chinese economic policy remains the focus following the country's announcement that it is continuing its measured effort towards revaluing its currency higher versus the United States dollar. In addition, subsequent to quarter end, the Chinese Central Bank raised interest rates on deposits by 25 basis points, the first increase in nearly three years, in an attempt to stifle inflationary pressures.

The consensus outlook for the next several quarters includes slowing GDP growth and continued high unemployment as household balance sheets struggle to move toward lower debt levels and more conservative consumption patterns. Emerging markets growth is expected to continue to outpace developed markets, with uncertainty surrounding developed markets' central bank and government policies likely to be at the center of attention for investors.

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS**
September 30, 2010

Assets

Equity in pooled cash and investments	\$ 164,079
Investments:	
Northern Trust	2,613,673,963
Aetna	14,887,216
Fidelity - Elected Officials Plan	719,152
Fidelity - DRSP	5,157,442
Total investments	<u>2,634,437,773</u>
Contributions receivable	<u>6,540,786</u>
Total assets	<u>2,641,142,638</u>

Liabilities

Benefits payable and other liabilities	<u>5,513,131</u>
Net assets held in trust for pension benefits	<u>\$ 2,635,629,507</u>

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
September 30, 2010

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 30,150,361	\$ 30,150,361
Member	4,640,375	4,640,375
Total contributions	34,790,736	34,790,736
Investment income	207,589,474	207,589,474
Less investment expenses	4,150,644	4,150,644
Net investment income	203,438,830	203,438,830
Total additions	238,229,566	238,229,566
Deductions		
Retiree benefits	32,237,392	32,237,392
Disability benefits	10,104,030	10,104,030
Survivor benefits	1,907,290	1,907,290
Refunds	480,068	480,068
Administrative expenses	563,602	563,602
Total deductions	45,292,382	45,292,382
Net increase (decrease)	192,937,184	192,937,184
Net asset held in trust for pension benefits		
Beginning of period	2,442,692,323	2,442,692,323
End of period	\$ 2,635,629,507	\$ 2,635,629,507